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C O N F I D E N T I A L SECTION 01 OF 03 ADDIS ABABA 001439

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SUBJECT: IMF: ETHIOPIA NEEDS "BRIDGE FINANCING" TO AVOID
ECONOMIC DISRUPTION

REF: ADDIS 1189

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Classified By: Ambassador Donald Yamamoto for reasons 1.4 (b) and (d).

SUMMARY

11. (C) International Monetary Fund (IMF) Article IV Mission Team Leader Robert Corker told representatives from the Addis Ababa diplomatic corps on May 19 that Ethiopia will require \$1-2 billion in "highly concessional bridge financing" over the coming year or two avoid a significant disruption of the economy while it adjusts its economic fundamentals. Corker emphasized that world oil prices imposed an additional \$1 billion (or four percent of GDP) burden on Ethiopia's import bill, which represents an "immediate crisis" that solid macroeconomic policies may overcome in four-to-five years at best. With 30 percent inflation, foreign exchange reserves so depleted to cover the equivalent of just six weeks of imports, and an overvalued birr, the Ethiopian Government (GoE) faces a significant challenge in stabilizing its economy without undermining growth. Because of Ethiopia's dire need for "bridge financing," a role which only budget support donors can truly play, the IMF team privately advised the GoE not to "pick fights with donors." In light of an improved quality of IMF-GoE dialogue, however, the IMF will send similar consultation missions every six months and is revisiting the previous decision to close its office in Addis Ababa. End Summary.

IT'S THE ECONOMY

12. (C) The IMF team expressed serious doubts about the GoE's official GDP figures, noting that "no one really knows what's going on." Despite 11 percent official figures, the mission suggested that recent GDP growth has been closer to 8%, which they assess as still being "too fast." Ethiopia's high population growth rate also means that per capita growth has been significantly lower than GDP growth. Further, the IMF noted that although the GoE budget is certainly pro-poor, "it is not evident that the economy has an adequate industrial

base to achieve the GoE's stated development strategy." Of particular concern was the fact that foreign reserve levels have been quickly and steadily declining, standing now only at the equivalent of six weeks of import costs. The IMF team argued that the rapid appreciation of the real exchange rate had gone too far. They assessed that the birr "is not majorly overvalued" because some of the appreciation has been an equilibrium adjustment to bring domestic food prices in line with world prices. Still, the IMF team argued that if the overvalued birr is not addressed soon, the increase in Ethiopian demand will require a big adjustment later. Fundamentally, the mission warned donors to expect the Ethiopian economy to soften in GoE FY08-09 relative to the past four years' growth.

13. (SBU) The predominant factor fueling the current balance of payments imbalance has been the \$1 billion shock to the economy -- the equivalent of 4 percent of GDP -- sustained due solely to the rise in world oil prices and strong Ethiopian demand. The team called the situation an "immediate crisis." Whereas Ethiopia had a fuel import bill of \$750 million last year, this year it is expected to rise to \$1.75 billion -- well over the value of Ethiopia's export earnings. "The oil shock will constrain growth to around seven percent" in the best case scenario the IMF assessed, and in the best case and with solid macroeconomic policies, Ethiopia will only be able to overcome that shock in four to five years. Due to the increases in the price of oil and the level of Ethiopian demand, a 20 percent increase in Ethiopian exports and an optimistic increase in Ethiopia's imports of only five percent today would still leave the balance of payments unchanged. If exports grow at a slower pace, or imports at a faster pace, the balance of payments will only slip further from equilibrium.

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14. (SBU) On a more positive note, the mission argued that the rising food inflation over the past few years is largely domestic phenomenon largely unaffected by rising world food prices. Further, it appears to be correcting the historical imbalance of domestic food prices, which have long been below world price levels. As such, the mission suggested that the food inflation is an "adjustment" which will not likely continue beyond the duration of the correction process. With food prices in Kenya higher than in Ethiopia, the IMF noted that food is being smuggled across the border, thus reducing food supply in Ethiopia by an estimated five percent.

THE IMF'S POLICY PRESCRIPTIONS

15. (C) The IMF team noted that the GoE took some demand and money supply restraining actions based on the Fund's November 2007 consultation. Three factors that could not be predicted, however, 1) the world oil price increase, 2) the degree of inflationary expectations among the public, and 3) the level of public enterprise spending together "nullified the effects of the GoE's actions." The mission emphasized that the GoE needs solid macroeconomic policies and must brace the economy to absorb the oil import bill. While the Fund advised that the GoE tighten demand and credit, it advised that these efforts be introduced through a gradual approach. While the mission was clear that these moves will certainly have a real consequence on growth, the question is the extent of those consequences based on the implementation of fiscal and monetary restraint.

16. (C) GoE admitted to the IMF that it knows "that they must demonstrate that their house is in order." The IMF team said that the GoE agrees with the direction of the IMF's recommendations, but there remains a question as to agreement on the degree of policy reaction. Apparently the GoE has begun limiting the rate of money growth from the current 23% to 18%. Corker argued that the GoE is much more optimistic about export growth projections than the IMF, but even if

they are accurate, the balance of payments gap is "just too big to be address by expanding exports alone." The IMF admitted being "pessimistic" about the potential for much growth in exports, if any, if Ethiopia does not get budgetary help. Without providing further detail, Corker noted that the GoE is at least "looking at the public sector in a more holistic view" (i.e. government budget as well as public enterprises). The team recommended that the GoE reduce its total deficit from roughly 4.5% to 2-3% and increase the proportion of government spending while reducing public enterprises spending. Apart from the specific economic recommendations, the IMF's key overarching recommendation to the GoE, in light of it clear need for concessional bridge financing from outside is "don't pick a fight with donors."

RISKS TO THE NEEDED ECONOMIC ADJUSTMENT

¶16. (SBU) While the IMF team was clear on the need for a tightening of fiscal and monetary policies by the GoE, the base challenge is how to address inflation and the imbalance of payments without overly stymieing growth. Even with strong policies, the public expectation of further inflation is itself a risk. Sustained expectations of inflation could further fuel actual inflation, thus requiring a more significant tightening of monetary policy to constrain, causing a further economic slowdown. Corker argued that there is a case for a depreciation of the birr. If the GoE does choose to adjust the exchange rate, however, the IMF recommended that it do so in a "controlled manner" so as to avoid fueling further inflationary expectations or economic discord among the public. Fundamentally, the IMF team argued that either "highly-concessional bridge financing" is needed in the next year or two or the GoE will be forced to clamp down severely on the economy to tackle inflation. Corker stressed that there would be "significant downside risks if

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there is no donor budget support."

IMPROVED DIALOGUE WITH THE IMF

¶17. (SBU) Despite facing a clear challenge in executing the needed economic adjustments without impeding growth, the GoE's engagement with and openness toward the IMF team during their May 12-19 Article IV consultations was better than in previous years. As evidence of improved relations, the GoE reportedly provided full information to the mission on public enterprise accounts for the first time. Corker confirmed that there is still "no chance" of an IMF program with Ethiopia, "as the GoE is simply not interested," but he did argue that the GoE does appreciate and consider the IMF's advice. While the team conceded that if they had an IMF program, they would probably be tougher on the GoE, Corker argued that because the GoE is happy with its close dialogue with the IMF, similar IMF missions will now be repeated every six months, with the next to return in November. While a final decision is still to be made, Corker disclosed that he is "optimistic" that the IMF ResRep office in Addis Ababa would remain open despite having previously been slated for closure.

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